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To: Market Advisory Committee

From: Lenny Goldberg, TURN and CTRA

Re: Comments on draft report

We appreciate the draft report for its comprehensiveness and its willingness to address difficult issues. You have examined the issues in an intellectually rigorous way that establishes a solid analytical basis should California move ahead with a cap and trade program.

Our past comments have focused on the question of auction vs. free allocation, and you have addressed most of the issues to our satisfaction. In particular, you note that under auction, early action is its own reward; that free allocation involves a wealth transfer and windfall profits to those receiving the allocation; that auction is simpler to administer because firms themselves identify the amount of credits they need to buy; that auction avoids perverse incentives; and that the revenue from auction can advance the cause of controlling global warming.

In these comments, we first take issue with one over-arching statement with regard to this subject, second, offer a recommendation with regard to phasing in the program, which also addresses the critical issue of utilization of the revenues from auction, and third, comment about the inclusion of the transportation sector.

1. Environmental impacts of auction vs. free allocation.

The statement at issue is that the decisions on auction or free allocation “will not have an impact on the environmental result of the cap and trade program.” This statement gives ammunition to those who would seek a much less effective program, permitting them to argue that the auction issue is only about economic and social burden and not about controlling global warming. Your own report contradicts this position.

The statement in full is as follows:

“...it is critical to understand that these decisions will not have an impact on the environmental result of the cap-and-trade program. The initial distribution of allowances clearly affects the distribution of costs for meeting California’s emission reduction targets. Under certain circumstances it affects the overall costs. But *under no circumstances* (emphasis added) does allowance distribution affect the achievement of the targets themselves”.

We understand the economic argument which informs this position. It is a static view which says that, if emitters are given free allowances, the opportunity cost of holding or selling that allowance

will have the same impact on behavior as if the emitter of carbon had purchased the allowances, leading to the same environmental outcome, particularly given the cap they are operating under.

But the question of the specific impact on behavior of the firm's decision-making (which by itself is arguable among economists) ignores the dynamic, real-world context of the program. And much of your own chapter on auction belies that sweeping statement.

Take the obvious question of revenues, addressed in section 6.1.2. Among the suggestions you make include: investment in energy efficiency, investment in low GHG-producing technology, incentives for clean-up, investing in local improvements in impacted areas, and investments to improve the global-warming affected ecosystem, in addition to mitigation of the social and economic impacts.

It is unquestionable that free allowances generate no revenues for these improvements, and that auction revenues allow for the range of improvements described in the report, as well as mitigation. How can these not be considered part of an environmental impact of the cap and trade program? They clearly make a huge environmental difference. Economic analysis notes the "double dividend" which stems not only from the incentive but also from reinvesting the revenue. It would admittedly be possible to spend those revenues in a way that does not lead to environmental improvements, but in the absence of those revenues there is no possibility of such investments.

You also note that early action is rewarded by auction, and that free allowances create "perverse incentives". This is, in effect, the addition of a dynamic approach to the static model which suggests no environmental impact. In a dynamic context, the announcement of auction several years hence does exactly what you state: provides a direct incentive to early action. Similarly, the distribution of free allowances provide a "perverse incentive" to hold off on making improvements. Thus, there is an environmental opportunity cost of continued emissions by failing to announce a future auction. How can early reduction not be considered an environmental improvement, or an incentive to delay action not be considered an environmental detriment?

Further, the question of ease of administration and limitation on costs has environmental consequences. You have noted that administrative allocation, done for free, is not only costly and difficult but may not be done correctly. On the other hand, if they have to purchase permits, emitters will attempt to minimize their purchases, and will know themselves the quantity of permits they need. The whole point of a cap and trade program is to seek program efficiencies and least-cost operations, as a benefit to the environment. To the extent, as you say, that "overall costs" are reduced, those savings work to benefit the environment by virtue of more efficient achievement of goals, with savings that can be directed to otherwise improving the program.

In fact, if it is the position of this report that efficiencies and lowered costs have no bearing on environmental effectiveness, the entire report should begin with the statement that the entire trading program has no impact on the environmental outcomes, and only allows the same outcomes to be reached more efficiently. But because of opportunity costs, not to mention political resistance to change, to the extent that both the trading program and auction each contribute to lower costs and greater efficiencies, they also contribute to improving environmental outcomes.

We believe that the blanket statement in this section should be re-phrased as follows:

While the decision to auction or allocate allowances for free may have the same environmental result with regard to the decision-making of those who hold the allowances, the overall environmental impact of the program will be enhanced by auction in its start-up phase with regard to sending the right market signals, in cost savings and efficient operation of the program, in the permit allocation decision, and in particular from the revenue it generates to the extent those are reinvested to accelerate the program of lowering carbon emissions.

2. Phase-in period and revenue allocation.

The issue of revenue allocation from auction is a critical one, and there is a very broad range of opinion on this: carbon credits to consumers, tax relief for low-income individuals and impacted businesses, investments in technology, subsidies for transit, local mitigation and environmental improvements, energy efficiency and other opportunities.

Given the broad range of differences and options, we believe that the MAC could be helpful in recommending a process, some criteria, or at least the questions to be addressed in revenue allocation. While the decision will ultimately be the legislature's, another pathbreaking role for the state should be to develop a serious public policy framework for how to spend revenues from carbon charges.

Serious analytical work will be necessary along the following lines: what groups and/or businesses are bearing a disproportionate burden with regard to change, and how can those be mitigated; where are the expenditures which give the most bang for the buck with regard to shifting to a lower-carbon-emitting economy; which are the most promising technologies, and to what extent will they be adopted by the market or to what extent will they need subsidies; what sets of tax and subsidy policies will be most effective in terms of transformation.

To do this work, the MAC should recommend the rapid imposition of a carbon permit fee, as provided by section 38597. (The ARB has indicated that they could begin a fee by 2009, well in advance of the proposed cap and trade program). That fee would serve double duty: first, it would, over time, define the universe of carbon permit requirements, and work through many of the issues addressed in several chapters in the report. With the beginnings of an at-first modest fee, issues such as upstream/downstream, load-based/first seller, fugitive emissions, and accounting and data issues can all be addressed and adjusted prior to the beginning of the auction process. We would recommend, consistent with scenario 4, that it be collected via the upstream approach.

Second, a carbon permit fee can finance the process of intensive analysis with regard to the appropriate use of auction revenues, and the on-going requirements of making a cap-and-trade market work. Too often, the legislature makes decisions in a "data-free environment"—one which depends more on the persuasiveness of advocates than analytical, data-rich, and scientific studies. The funding available from a permit fee will set up, in effect, a roundtable by which the issues can be analyzed and debated by the full-range of advocates, with funding for appropriate studies of burdens, incentives for change, and promising technological and economic changes. In addition, significant work will be required with regard to analyzing how to make a market work efficiently. While ultimately the legislature makes the decision, in terms of the demands of global warming, it should be as well-informed as possible.

3. Comments with regard to including transportation fuels in the cap and trade approach

The inclusion of transportation fuels, collected at the refinery or wholesale rack, provides an important element in the program, one which will move California beyond RGGI, which only proposes to auction electricity at this point. We support the MAC report in this respect.

We believe that include transportation fuels in the auction will operate in a manner consistent with the low-carbon fuel standards which are likely to be in place. That is, a permit fee based on carbon content will provide incentives and encouragement for the more rapid adoption of lower-carbon emitting fuels. As you note, the standard for fuels and the broader question of aggregate emissions are separate issues.

There are two additions we might suggest to this section. First, unless there is an unexpected ability to diminish the amount of transportation fuel demanded by the public, as the cap is reduced, the price of permits may rise considerably beyond current estimates. And transportation fuels, to the extent that substitutes are limited, may bear an increasing burden of the responsibility to purchase permits in the market. Thus the relatively small price increases anticipated in the report (8.8 cents in \$10 of CO₂ equivalent price) may become far more considerable, and have the desired incentive effect of diminishing demand and forcing technological and behavioral change.

Second, given the relatively oligopolistic structure of the oil industry, some attention must be paid to the potential for concentration of market power in the carbon emissions permit market. To the extent that oil companies have little choice but to purchase permits for all fuels, their ability to exert influence in the market is limited. But to the extent to which they are in a position to purchase excess permits (with, say, tightened fuel economy standards), there is the potential for gaming in the market.

And, of course, with upstream permitting—which we support—there needs to be close market monitoring. In chapter 7, you make some suggestions for on-going administration of the program. However, this section should explicitly acknowledge the need for market supervision. We urge the Committee to make suggestions for an on-going structure to monitor market power in the carbon permit market, such as the market surveillance committee of the ISO, in the context of CARB's overall administration.

In summary:

1. The report should be modified, as suggested above, to note that in a dynamic, real-world context, auctioning is likely to have positive environmental benefits as well as addressing distribution of the burden of a cap-and-trade system.
2. The report should recommend beginning with a carbon permit fee, as a means of funding necessary studies with regard to spending the revenues from auction and to further explore the requirements for successful operation of a cap-and-trade market; and also to provide valuable feedback with regard to the issues and data involved with a system of carbon permits. The fee should begin in 2009, should ramp up, and be converted to an auctioned price when and if the market begins in 2012.

3. We support the inclusion of transportation fuels in an upstream system, and note two additions: first, that the incentive effects may increase rapidly to the extent that substitutes are less available for transportation fuels than for other carbon-emitting substitutes; and, that concentration of market power may be substantial in the carbon market, and an on-going market surveillance mechanism should be suggested in the report.